Should Great Britain remain outside the eurozone?

Britain and the Euro – Just Say No?

By **Uwe Bott** | Friday, June 06, 2003

Since the euro was first conceived in 1992, Britain has maintained a consistent opt-out policy. In 2002, Tony Blair's Labour Government pledged to revisit the issue. It promised to provide Parliament with a recommendation on whether to join the single currency that would be based solely on economic grounds. Uwe Bott argues that a strong economic case can be made for Britain to remain outside the eurozone.

On June 9, 2003, a watershed event in the annals of European history is supposed to happen.

Politics trumps economics

On that day, Britain's Chancellor of the Exchequer, Sir Gordon Brown, will submit his report to Prime Minister Blair evaluating the advisability of British accession to the euro. The political aspects of the British decision are undeniable.

The adoption of the single European currency has much greater costs than benefits — and that will continue to be the case for years to come.

Truth be told, the overriding rationale for the euro was political in the first place. Gordon Brown's recommendation will center, however, around five economic tests tailor-made for the UK case.

These criteria focus on a convergence of business cycles between the UK and the eurozone, economic flexibility and whether the euro will have a positive impact on employment, investment and the financial sector in Britain.

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Yet, an even more compelling question to ask would be whether the euro has indeed proven to be beneficial to those 11 countries that adopted it in 1999 (which were joined by Greece in 2001).

Is the eurozone an optimum currency area?

The eurozone is not an optimum currency area. Broadly speaking, economists refer to an optimum currency area when business cycles across that area are relatively synchronized.

Most U.S. economists — many of whom are euro-skeptics — freely admit that such an optimum currency area does not even exist in the United States. But business cycles in different U.S. regions move much more in unison than in the eurozone member countries.

Economic convergence criteria

A single currency requires a high level of economic convergence. Otherwise, the costs of so-called asymmetric shocks (that is, economic events that affect member countries differently, such as rising oil prices) will exceed the benefits of a common currency (including lower transaction costs and eliminated currency risk).

The Europeans tried to fix this problem by agreeing on a set of convergence criteria in the Maastricht Treaty. It is intended to accelerate the process of economic convergence between the different countries. The main tools were to bring interest rates, inflation and budget deficits into sync.

European monetary policy does not really suit anybody in the eurozone. This is the worst of all worlds.

But convergence is a lengthy process that cannot be accomplished by decree.

In the short term, eurozone countries — with some fudging — achieved general compliance with these criteria. But the structural differences in the member countries — over time — will make these constraints unbearable for some.

A one-size-fits-all monetary policy

We are already at the breaking point because of enormous growth differentials among the countries of the eurozone. Germany and France have anemic growth, while Ireland and Greece are growing at a rapid pace.

Facing the risk of Germany and France falling into a low growth/deflationary trap, the European Central Bank reacted on June 5, 2003, when it lowered interest rates across the eurozone by 0.5 percentage points.

Reasons to keep a safe distance

Interest rates across the eurozone are now at their lowest level since 1950. But this does not help Ireland and Greece, where rates should be higher — since strong economic growth has increased inflationary pressures in those economies.

The overriding rationale for the euro was political — and nobody felt "authorized" to argue with that rationale.

European monetary policy does not really suit any country in the eurozone. This was exactly the fear many euro-skeptics had from the start.

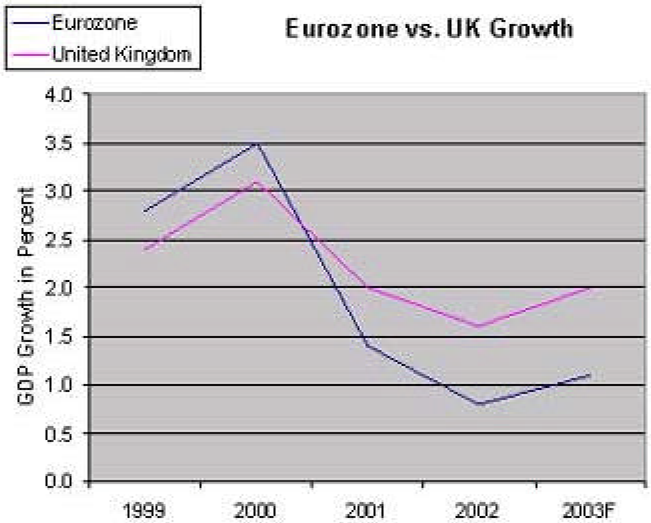
With 10 new members set to join the EU in 2004 — and likely joining the euro some time thereafter — the eurozone will become even less of an optimum currency area. The process of making monetary policy decisions will become even more convoluted, controversial and counter-productive.

These red flags alone should be reason enough for the United Kingdom to opt out of joining the eurozone at this time. But there are even bigger reasons for the UK to hold back.

A comparison of economic performance

The table below shows that economic growth in Britain has outpaced growth in the eurozone since the euro's introduction in 1999.

While this is due to a number of factors, sound monetary policy by the Bank of England — tailored to the needs of the British economy — certainly played a significant role in this strong performance. Inflation has also been kept under control without creating a deflationary environment.



A way out for the eurozone

Some economists still see value in a single currency, however, even if the region in question does not have well-synchronized business cycles.

This shortcoming can be offset by labor mobility, wage flexibility and/or fiscal transfer mechanisms in the region that shares a single currency and monetary policy.

Labor mobility

Of course, legally speaking EU citizens are free to move around within the EU territory to seek employment opportunities.

Practically speaking, this is not the case. There are many reasons for that—primarily language and cultural barriers. Even within the territory of any European nation state, labor mobility is far below that of the United States.

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Why is labor mobility so important? The reason is that it acts as adjustment mechanism in an area that shares a common currency.

Labor mobility means that, during times of economic distress in one region or country, some portions of the growing pool of unemployed should be moving to countries with rapid growth and emerging labor shortages.

Wage rigidities

Over time, this leads to wage adjustments, which are crucial. However, Europe's high degree of unionization and generous unemployment benefits — especially in the “richer,” yet slow-growth EU countries — have contributed to the lack of mobility.

This highlights that a single European currency should have been preceded — not followed by — structural reforms, particularly in the labor markets of countries such as Germany or France.

Absence of a fiscal authority

Finally, the eurozone is also unable to compensate for asymmetric shocks through automatic fiscal transfers.

Fiscal policy is one of two key tools of economic policy-making. To deprive oneself of this tool is simply foolish.

In fact, only a tiny fraction of tax revenues collected by the member countries' governments is actually passed on to the EU level.

There are no fiscal transfers from high-growth countries (with ample tax revenues) to struggling low-growth countries (with low tax revenues) that could serve as stabilizers to bring their economic performance back into sync.

Even the United States has mechanisms by which to balance some of the existing inequities between the states of the union.

A fiscal straightjacket?

In times of fiscal distress, policymakers in the eurozone thus face significant challenges. They have no influence over monetary policy — since interest rates are set at an eurozone-wide level by the ECB. They also cannot weaken their currency to make their economy more competitive internationally.

To make matters worse, the Stability and Growth Pact obliges all members to pursue austere fiscal policies. Budget deficits may not exceed 3% of GDP at current — and fiscal accounts, at least in theory, are to be in complete balance by 2006.

Economic realities

The Stability and Growth Pact is doubly unhealthy. Of course, fiscal prudence is a laudable objective. However, having already given up control over monetary policy, it is simply foolish for many European countries to deprive themselves of the tool of fiscal policy as well.

Governments are left helpless and hapless in the face of ordinary business cycles.

It is not advisable for countries that have so far stayed out to join at this point especially when their economic structures are modern and competitive.

The euro has become an economic and historical reality. There is very little likelihood that the current participants in the eurozone are going to reverse this process.

However, the adoption of the single European currency has much greater costs than benefits — and that will continue to be the case for years to come.

Should Britain still join?

Therefore, it is not advisable for countries that have so far stayed out to join at this point. This is especially true when their economic structures are modern and competitive — and when their monetary policy is up to the task at hand.

The answer for Britain, therefore, is easy — provided that the country follows the only form of evaluation that should matter, an economic one.

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